

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:[REDACTED]:1:POSTF-126566-02
[REDACTED]

date: JUNE 5, 2002

to: Group Manager [REDACTED]
Attn: Team Coordinator [REDACTED] (LMSB:FS:Team [REDACTED])

from: [REDACTED]
Associate Area Counsel
(Large and Mid-Size Business)

subject: [REDACTED]

This memorandum responds to your request for assistance dated [REDACTED]. This memorandum should not be cited as precedent.

Issues:

1. Whether the bank owned life insurance program sold by [REDACTED] Company qualifies for "the special rules relating to the payment of proceeds" set forth in Treas. Reg. § 1.848-1(h)(7)(i).

2. Whether the bank owned life insurance program sold by [REDACTED] Company qualifies as a group life insurance contract under section 848(e)(2) and Treas. Reg. § 1.848(h)(1).

3. Whether the correct capitalization rate for the bank owned life insurance premium for the program sold by [REDACTED] Company is [REDACTED]% under section 848(c)(1)(B) or [REDACTED]% under section 848(c)(1)(C).

Conclusions:

1. The bank owned life insurance program sold by [REDACTED] Company fails to qualify for "the special rules relating to the payment of proceeds" set forth in Treas. Reg. § 1.848-1(h)(7)(i).

2. The bank owned life insurance program sold by [REDACTED] Company fails to qualify as a group life insurance contract under section 848(e)(2) and Treas. Reg. § 1.848(h)(1).

3. The correct capitalization rate for the bank owned life insurance premium for the program sold by [REDACTED] Company is [REDACTED]% under section 848(c)(1)(C).

Facts:

[REDACTED] Company (" [REDACTED] ") is a [REDACTED] company owned by [REDACTED] (" [REDACTED] " or the "parent"). [REDACTED] files a life/non-life consolidated federal income tax return (Form 1120). The life insurance subgroup includes [REDACTED]. The non-life subgroup includes a non-life/non-P&C subgroup and a P&C subgroup called the [REDACTED]. Included in the non-life/non-P&C subgroup are the parent corporation and other related corporations that do not qualify as life or P&C insurance companies. The P&C subgroup files a consolidated Form 1120-PC return which includes only qualified property and casualty insurance companies.

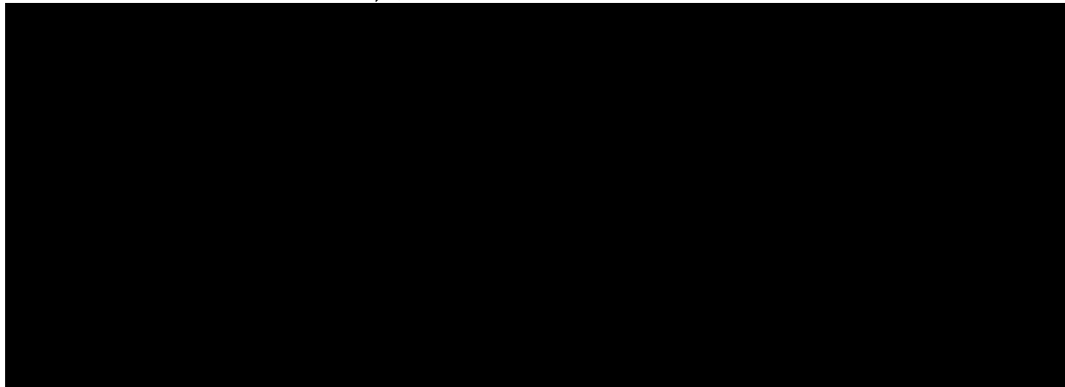
The life subgroup files a Form 1120-L as an attachment to the parent's Form 1120. Generally, Schedules A through J to the Form 1120-L are used to compute life insurance company taxable income. In particular, Schedule G is used to compute policy acquisition expenses under section 848.

In [REDACTED], [REDACTED] was approached by [REDACTED] (" [REDACTED] ") and asked to make a bid to underwrite [REDACTED]'s bank owned life insurance ("BOLI") program. [REDACTED] chose [REDACTED]'s bid because of the competitive rates offered and because of [REDACTED]'s close working relationship with [REDACTED]'s parent. The common stock of [REDACTED] has been [REDACTED]'s largest portfolio investment for a number of years.

As a result of the acceptance of its bid, [REDACTED] wrote \$ [REDACTED] in BOLI premiums to the [REDACTED]. In the months prior to writing the premiums, [REDACTED] filed certain new Group Life Forms used to underwrite the BOLI program with the [REDACTED] Department of Insurance for its review and approval. According to papers submitted:

[REDACTED]

Moreover, as part of the actual BOLI transaction, a Memorandum of Understanding was executed between [REDACTED] ([REDACTED]'s parent) and [REDACTED]. Among the points set forth in the memorandum was the following:



In [REDACTED], for Federal income tax purposes, Life Co. reported the \$[REDACTED] BOLI premium as a group life insurance premium and capitalized [REDACTED]% of the premium as policy acquisition expenses. In particular, on its Form 1120-L, Schedule G, [REDACTED] capitalized \$[REDACTED] of policy acquisition expenses. This amount was applied to reduce [REDACTED]'s general deductions from \$[REDACTED] to \$[REDACTED], the amount reported on line 18 (other deductions) of the Form 1120-L. Based on current and prior years' costs capitalized, [REDACTED] reported \$[REDACTED] in deductible policy acquisition expenses, an amount calculated on line 20, Schedule G, and reported on Form 1120-L, line 16.

Analysis:

Congress added section 848 in 1990 to require insurance companies to capitalize specified policy acquisition expenses and amortize these expenses ratably over 60 months or 120 months, as appropriate. The term "specified policy acquisition expenses" is defined in section 848(c) as so much of the general deductions for such taxable year as do not exceed a stated percentage of net premiums. Section 848(c)(1). The stated percentage varies with the precise type of insurance, be it an annuity at 1.75%, a group life insurance contract at 2.05%, or "other" specified insurance contracts, including individual life insurance contracts, at 7.7%.

The term "group life insurance" is defined by section 848(e)(2) to mean any life insurance contract:

(A) which covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor,

(B) the premiums of which are determined on a group basis, and

(C) the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

Treas. Reg. § 1.848-1(h)(1) further provides that a life insurance contract is a group life insurance contract if:

- (i) The contract is a group life insurance contract under applicable law;
- (ii) The coverage is provided under a master contract issued to the group policy holder, which may be a trust, trustee, or agent;
- (iii) The premiums on the contract are reported either as group life insurance premiums or credit life insurance premiums on the insurance company's annual statement (or could be reported as group life insurance premiums or credit life insurance premiums if the company were required to file the annual statement for life and accident and health companies);
- (iv) The group affiliation requirement of paragraph (h)(2) of this section is satisfied;
- (v) The premiums on the contract are determined on a group basis within the meaning of paragraph (h)(3); and
- (vi) The proceeds of the contract are not payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person. (See paragraph (h)(7) of this section for special rules that apply in determining if this requirement is satisfied.)

Since questions exist regarding whether the benefits are inuring to the employer, Treas. Reg. § 1.848-1(h)(7) must be consulted. That regulation, in pertinent part, provides as follows:

(ii) Contracts issued to a welfare benefit fund. If a contract issued to a welfare benefit fund (as defined in section 419) provides for payment of proceeds to the welfare benefit fund, the proceeds are not considered payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are paid as benefits to the employee or the employee's beneficiary.

Issue 1:

Initially, we were asked whether the BOLI contract qualifies for the "special rules relating to the payment of proceeds" set forth in Treas. Reg. § 1.848-1(h)(7)(i). Satisfaction of that rule permits the conclusion that the proceeds of the policy were not considered payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person. In essence, that part of the special rule that is relevant here dictates that the proceeds of the contract will not be considered payable to or for the benefit of the insured's employer if the proceeds are paid as benefits to the employee or the employee's beneficiary.

From the facts provided, it does not appear that the "special rule" has been satisfied. Assuming for purposes of this memorandum that the BOLI contract was issued to a welfare benefit fund (as defined in section 419), we believe the facts fail to support the conclusion that the proceeds were paid as benefits to the employee or the employee's beneficiary.¹ Although circumstantial, the facts seem to suggest that the proceeds were paid to corporate policyholder, not to the employee or its beneficiary. Moreover, the proceeds, once received by the corporation, do not appear to have been set aside for use to satisfy employee benefit expenses. Instead, it appears that the plan was to commingle those proceeds with all other general funds. Like all general funds, the proceeds were available to the corporation for all uses and were not limited in use to any particular purpose. Under those facts, we believe the proceeds from the instant BOLI policy were NOT paid as benefits to the employee or the employee's beneficiary, and the taxpayer may not rely upon the special rule to avoid the conclusion that the proceeds were payable to or for the benefit of the insured's employer.

However, we caution that these conclusions are based on documents apparently describing how future payments would be applied. While instructive and relevant, of more importance is how the actual proceeds were handled, accounted for, segregated and applied. We suggest that you trace the actual proceeds and examine how the proceeds were accounted for and used. Any conclusions should be based on those facts, not merely the wording of the planning documents.

¹ We neither know to whom the contract was issued nor whether such party satisfies the requirements of section 419.

Issue 2:

The second issue posed was whether the BOLI policy qualified as a group life insurance contract. Section 848(e)(2) defines "group life insurance as a three-part test. Most relevant is the third part:

the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

Treas. Reg. § 1.848-1(h)(1) amplifies the definition of the term "group life insurance contract" to include six requirements, all of which must be satisfied. Without intending any inferences (either negative or positive) regarding the other requirements, for purposes of this memorandum we consider only the sixth and final requirement, which reads:

The proceeds of the contract are not payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person. (See paragraph (h)(7) of this section for special rules that apply in determining if this requirement is satisfied.)

Treas. Reg. § 1.848-1(h)(1)(vi).

The same facts used to determine whether the "special rule" of Treas. Reg. § 1.848-1(h)(7)(i) are relevant to the second issue. From the facts provided, it appears that the facts fail to support the conclusion that the proceeds were not payable to or for the benefit of the insured's employer. As noted already, the facts seem to suggest that the proceeds were paid to corporate policyholder, commingled with the employer's other general funds, and used by the employer in any manner chosen by the employer, subject only to the employer's discretion. Under those facts, it appears that the proceeds from the instant BOLI policy were payable to or for the benefit of the insured's employer. Under those facts, the BOLI contract fails to qualify as a group life insurance contract as defined in section 848(e)(2) and Treas. Reg. § 1.848-1(h)(1).

Issue 3:

The final issue addresses the proper capitalization rate under section 848(c)(1) for the BOLI contract sold by [REDACTED] Company. At issue is whether the [REDACTED]% rate, applicable to group life insurance contracts, or the [REDACTED]% rate, applicable to contracts not considered either annuity contracts or group life insurance contracts, is applicable to the instant BOLI contract. Life Co. claims that the BOLI contract is a group life insurance contract subject to the [REDACTED]% factor.

Under section 848(c)(1), the proper capitalization rate is either [REDACTED]% as assigned by section 848(c)(1)(A) to annuity contracts, [REDACTED]% as assigned by section 848(c)(1)(B) to group life insurance contracts, or [REDACTED]% as assigned by section 848(c)(1)(C) to contracts that are neither annuity nor group life insurance contracts.

There is no question that the BOLI contract is not an annuity contract entitled to the [REDACTED]% rate set by section 848(c)(1)(A). From the facts it appears that the proceeds from the instant BOLI policy were payable to or for the benefit of the insured's employer, causing the BOLI contract to fail to qualify as a group life insurance contract as defined in section 848(e)(2) and Treas. Reg. § 1.848-1(h)(1). Failing to qualify as a group life insurance contract, the [REDACTED]% rate assigned to group life insurance policies by section 848(c)(1)(B) is inapplicable. By default, the proper capitalization rate to be assigned to the instant BOLI contract is rate is set by section 848(c)(1)(C), [REDACTED]%.

The conclusions reached by this memorandum depend heavily upon the facts which were provided to us. If those facts are later determined to be inaccurate, the conclusions, likewise, will be inaccurate. Moreover, as you further develop facts surrounding the payment of proceeds, the actual accounting for the proceeds received, and the use of the proceeds, please keep us informed of your findings.

As always, you may contact me at [REDACTED].

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Associate Area Counsel
(Large and Mid-Size Business)

By: _____
[REDACTED]
Special Litigation
Assistant